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EC 1992

Perspectives on Agriculture

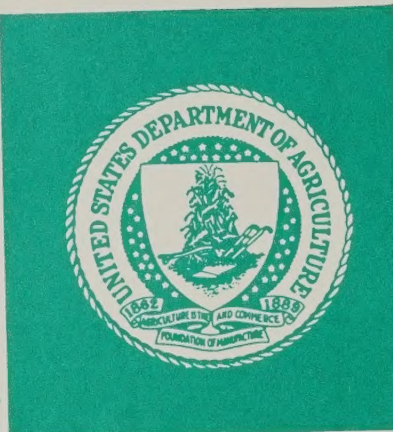
Walter H. Gardiner and
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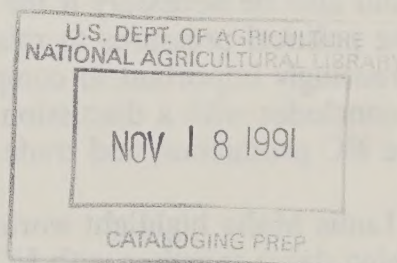
Abstract

This report contains five papers presented at a symposium during the 1989 annual meeting of the American Agricultural Economics Association in Baton Rouge, Louisiana. The papers focus primarily on the EC's 1992 program and its effects on agriculture. Other topics include the role and reform of the EC's Common Agricultural Policy, developments in the Uruguay Round of GATT negotiations, and U.S. trade and investment links to the EC.

Keywords: European Community, Common Agricultural Policy, 1992 Program, trade barriers, directives, GATT, world trade, investment, United States.

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May 1990

Preface

This report contains five papers presented at a symposium during the 1989 annual meeting of the American Agricultural Economics Association in Baton Rouge, Louisiana. The symposium was organized by David R. Kelch of the Economic Research Service (ERS) and moderated by John E. Lee, Jr., ERS Administrator. Other participants included Timothy E. Josling, Stanford Food Research Institute; Wilhelm Henrichsmeyer, Agricultural Policy Institute at Bonn, West Germany; Louis Mahe, Agricultural Research Institute at Rennes, France; and Walter Gardiner, ERS.

The first paper by Timothy Josling records the events shaping the 1992 Internal Market Program and the reawakening of interest in Europe. Josling discusses the reforms that have taken place in the Common Agricultural Policy (CAP) and relates these to the 1992 program and the Uruguay Round of GATT negotiations. He concludes that the 1992 program has longrun significance, both politically and economically, for the Community; the GATT is unlikely to drastically alter the CAP but will provide pressure for continued reform; apparent end of the Cold War will have important economic and political significance for the EC; and possible expanded EC membership with such countries as Austria, Norway, Sweden and Turkey will make for a very different Community by the end of the century.

David Kelch's paper compares and contrasts the harmonization process for plant and animal health regulations that are going on concurrently in the GATT and in the EC 1992 program. While the two harmonization programs appear complementary, Kelch expresses doubt that the two processes can be linked without interfering with the respective agendas of the two programs. He indicates that the EC is setting standards at the highest possible level that is politically acceptable which could affect future trade patterns. While the United States will likely be able to meet the new EC standards without much difficulty, the hormone ban, the red meat directive, and the possible use of the EC's fourth criterion (approval of a new biotechnology based on social or economic need) are areas of concern.

The third paper by Wilhelm Henrichsmeyer chronicles the principal forces since the early 1960's that have shaped the CAP: technical change, farm income pressure, commodity surpluses, rising budget expenditures. He stresses the importance of the decisions made at the 1988 Brussels Summit to make necessary supply and structural adjustments to EC agriculture. A restrictive agricultural price policy along the lines of recent years would also be necessary if the EC Commission and the Council of Ministers can withstand the political pressures to raise prices. The use of direct income transfers will become increasingly important to compensate for sudden price adjustments. Henrichsmeyer concludes with a discussion of the role environmental problems may play in limiting future EC production and trade.

Yves Leon and Louis Mahe highlight world events (depressed prices, slow economic growth, and foreign debt) together with EC events (commodity surpluses and large budget outlays) during the 1980's that have altered the CAP. They note that the EC's 1992 program has revitalized the faith in European integration but has relegated the CAP to a lesser role. They evaluate the role of France in the farm policy process and conclude that, while France has benefited from the high grain support prices under the CAP, high grain prices have constrained France's livestock sector, stimulated demand for imported cereal substitutes and protein feeds, and increased self-sufficiency in grains of

other EC countries. The authors conclude that, while the 1992 program and a border-free Europe will bring new pressures on reform of the CAP, the changes will be limited in the near term because of the network of contradictory forces that limit movement.

Walter Gardiner focuses on the implications of EC 1992 for the United States. U.S. interest stems from the strong trade and investment links it has had with EC countries in the past and the recent changes: slower growth in U.S. merchandise exports, a trade deficit, declining U.S. agricultural exports, and an increase in U.S. direct investment. Gardiner notes that 1992 will provide increased opportunities for those able to compete in a deregulated economy, especially companies already in Europe that are making necessary adjustments to respond to a pan-European market. Elimination of EC custom regulations at internal borders should significantly lower transportation costs for domestic producers and exporters of food and agricultural products. While the United States embraces the goal of a more unified Europe, it is closely monitoring the process to make sure the directives do not restrict market access.

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Europe 1992: Cap Reform, and World Agricultural Trade

by

Timothy Josling

Introduction

Four years ago, in June 1985, the European Commission issued a White Paper entitled "Completing the Internal Market." The notion was to remove, by the end of 1992, the myriad of obstacles hindering establishment of a truly integrated market within the European Community.

One month later, the Commission issued a Green Paper entitled "Perspectives for the Common Agricultural Policy." This discussion paper contained a major review of the CAP in the light of escalating budget costs. Consultation on the basis of the Green Paper led to a series of guidelines ("A Future for Community Agriculture") which laid out a strategy for dealing with surplus capacity in EC farming.

These two events, and the processes that they put in train, have led to somewhat different reactions in the United States. The 1992 program has led to a reawakening of interest in the EC by United States businessmen and politicians. After a decade of benign neglect, the "Old Continent" is back on the agenda. By contrast, Common Agricultural Policy (CAP) reform has been treated with skepticism and disdain by the United States and other agricultural exporting interests.

Both reactions are probably overstated. The Commission's agenda for completing the internal market, even if fully adopted, will not overnight turn a stagnant and divided Europe into a united dynamic force in world affairs. The creation of a full economic union in Europe is still not on the political horizon. Similarly, the act of slowing down, stopping, and turning around the juggernaut of the CAP is indeed a political event of some importance, and together with the institutional changes that have occurred in recent years, it argues for more responsible agricultural policies in the future.

My task is not, however, to prick the bubble of 1992 or sell the notion that CAP reform has started. Rather it is to draw out the connections between these two developments and their relationship to a third set of issues being faced in Geneva in the Uruguay Round of GATT negotiations. Other presentations will provide some detail on the 1992 plan and on the changes in the CAP. I will try to provide a perspective from which to view these policy developments.

EC Policy Process

To understand 1992, it is useful to think of three levels of policy and decisionmaking in Europe, each level with its own agenda and objectives. At one level are the national politicians, still running the show despite 30 years of Community existence. National attitudes on economic and political matters differ widely, and within countries there are sharp differences in ideology. Greek Socialists have little in common with British Conservatives, and yet the Community is founded on the myth that such diverse views can coalesce and make sensible policy. At the next level of decisionmakers are the

Community officials in the Commission and the politicians in the Parliament. Although they also hold diverse views, the bureaucratic and institutional objectives (including survival and expansion) tie them together. The third level of policy decisions are taken in the corporate board rooms (and union headquarters) of the private sector. Competing for the consumer's dollar (pound, franc, deutschemark, etc.) rather than their votes, they have less interest in the nationality of the buyer and more in her purchasing power.

In this light, 1992 can be thought of as a scheme hatched by the Community bureaucrats to further their own (often legitimate and laudable) objectives, which happened to land on the fertile ground of national politics looking for a way of regaining momentum in the global economic race. The Commission proposed the 1992 program as a way of removing national barriers to commerce within the EC and of placing more of the regulatory levers at the European level. The national governments saw the program as a way of promoting deregulation within the EC and stimulating the growth in employment and income that had eluded them for a decade. The prospect of a strongly growing Europe as a third pole in the magnetic field of the global economy (along with North America and the Pacific Rim) was evidently enough to overcome fears of feeding the regulatory appetite of Brussels.

The whole project might be dismissed as the delusions of frustrated politicians and ambitious bureaucrats if it were not for the reaction of the private sector. The national governments, in an attempt to justify their own conversion to the vision of a completed market, started promoting the idea back home. Business took the rhetoric at its face value, and began to treat the creation of a true common market as a realizable goal within their planning horizon. The notion of being able to locate businesses in one country and serve the whole internal market (or a particular market segment) proved irresistible. The flurry of mergers and acquisitions on the corporate scene is evidence of the importance of 1992 in the eyes of the businessman. It is this reaction which gives momentum to the program and makes its completion (if not by January 1, 1993, then soon thereafter) look inevitable.

The story of CAP reform also involves the Commission, the national politicians, and the private sector (this time, including farmers). The Commission has made numerous attempts over the years to reform the CAP. National politicians, on the other hand, saw neither votes nor jobs in the prospect (except perhaps in the United Kingdom) and made modifications to the CAP painfully slow and inadequate. The introduction of dairy quotas in 1984, on the face of it a significant policy departure, was really a "temporary" measure hastily introduced to avoid the need to cut milk prices. Farmers encouraged the notion that their incomes and livelihood were threatened by CAP reform, and even began to support the move toward quotas as a way of keeping high prices. The food industry, often tied to the processing of domestic output, made little attempt to encourage efficient production (their margins often being built-in to legislation). Nonfood sectors seemed genuinely unaware of the harm that an overexpanded agricultural sector was doing to their own competitiveness in foreign markets.

1992 Links With Agriculture

In agriculture, there has been no Pauline "conversion" on the road to economic reform. Nevertheless, attitudes do seem to be changing. The continuous irritation of agriculture

in trade and budgetary affairs has taken its toll, and has led to the widespread view that "something" had to be done. To a politician, all change is costly: reform takes place when the cost of doing nothing exceeds the cost of change.

In agriculture this point was reached in 1986. Agricultural spending threatened to undermine the stability of the EC and agricultural trade problems threatened to bring down the GATT. In September 1986, the EC agreed to start trade talks aimed at bringing agriculture fully under the rules of the General Agreement on Tariffs and Trade (GATT). For the first time, domestic price support policies were "on the table."

In December 1986, the Council of Ministers agreed to a package which put teeth into the dairy quotas and significantly weakened the price supports for beef. In October 1987, the Commission tabled a plan in the GATT which called for a substantial reduction in protection levels over a period of years (though they rejected the U.S. notion of a phase-out of all trade-distorting protection). By February 1988, a package deal had been hammered out in the EC which limited agricultural spending, and placed penalties on overproduction of a number of commodities.

The link between 1992 and CAP reform is strong but indirect. The Commission's ambitious List of 300 Directives (now down to 279) to complete the internal market contained no agricultural provisions, though 100 of the directives deal with food products. Despite this, the 1992 agenda has significantly influenced agricultural policy. The political need to keep the 1992 program on track was a major impetus behind the February 1988 CAP reform package, and the budgetary consequences of failing to act on agriculture appeared at that time to threaten the viability of the 1992 program.

The Single European Act, which entered into force in mid-1987, gave a much-needed institutional shakeup to the Community decision process. Though not directly involving agricultural decisions, it:

- o extended the scope for weighted majority voting to include most of the internal market program;
- o enhanced the power of the European Parliament;
- o gave a boost to regional development policy and to scientific and technology policy; and
- o pledged coordinated action on the environment.

This act, the first significant treaty amendment since 1957, seems to have been just the tonic needed for tired administrators and jaded politicians. Europe woke up and started to act: squabbles over agriculture were not going to hold up progress.

In such a flurry of Community activity, one aspect almost got lost. The rest of the world began to take an interest in the new face of Europe. Would a post-1992 Community be inward-looking or outward-looking? The prospect of "Fortress Europe" came readily into view. How else could one satisfy injured domestic competitors but to build up the outside wall? The discussions on internal liberalization of financial services was a bad omen: the Commission proposed a test of "reciprocity" which would have excluded U.S.

banks from entering EC markets unless broad changes were made in the U.S. banking laws. The proposals were finally toned-down, but not before the damage had been done to the external image of 1992.

The GATT Connection

The GATT Round becomes rather crucial in this process of completion of the internal market. A full endorsement of multilateral trade regulations, including an agreement on services, a better dispute settlement procedure, and a resolution to the agricultural trade problems would be a strong counter-weight to a more protectionist Europe. The political push for 1992 was indeed to give Europe a competitive position in a free multilateral trade environment. A breakdown of the GATT Round would however have serious impacts on the external face of 1992. A dash to bilateralism and regional trade associations is clearly on the cards in such a situation. The Community is unlikely to be an island of economic liberalism in a sea of trade protection.

The GATT Round is equally tied up with CAP reform. The February 1988 agreement was only the start along a long road to a market-oriented CAP. The pact was possible because budgetary imperatives coincided with political incentives to control CAP expenditure. But the will to hold down prices in years when budget pressures are relaxed is already being tested. And full reform needs more than temporary measures to link prices to output targets. An agreement in the GATT to scale back levels of support to agriculture over a period of years would be just the thing to keep CAP reform on target.

Unfortunately, there are reasons why one should not expect smooth and coordinated progress on all three fronts: 1992, CAP reform, and the GATT. It is not clear, for instance, that the EC is really in a position to negotiate a serious reduction in farm protection in the next 17 months. In the short-term perspective of politics, the agricultural issue has been "solved." CAP spending has been brought under control, and a deal has been made with the United States in the GATT to freeze support prices for the next 2 years. As institutional prices in ECU have been frozen or reduced for the past 4 years, this will require no major policy adjustment. The Commission continues to propose price reductions on the basis of an "aggregate measure of support" (measured relative to fixed world reference prices), but the United States seems to be moving away from such a notion. In place, the United States is asking the EC to convert its variable levies into tariffs. However desirable this might seem from the outside, it would require such a dramatic shift in policy responsibility internally (taking away from the Council of Ministers the right to set annual prices) that it is unlikely to be agreed without considerable concessions on the part of the exporters. What these concessions might be is not clear, but the EC could be expected to push for "rebalancing" its support levels among commodities, by imposing levies on cereal-substitutes and on oilseeds.

It is also not clear at present whether the symbiosis between 1992 and CAP reform will continue. The concept of a free internal market has some implications for EC agriculture which might prove contentious. Although the Commission's proposed directives do not address agricultural trade, which is in any case supposed to be "free" across internal borders, the removal of border controls (which is an important symbol of a free internal market) would have a major impact. This is particularly true for commodities whose production is subject to national quotas (milk and sugar) and where the system of "green-currencies" requires border tax adjustments. It is difficult to

conceive of border posts existing solely to keep track of farm produce, but without them the administration of quota policies and inter-country price differentials becomes tricky. Similarly, other policies which require national differentiation, such as the sheepmeat regime, will come under pressure to change.

Agricultural complications will certainly act to slow down the completion of the market. But it is possible that the single market may in the end have a decisive effect on agriculture. The impact on the food industry of mutual recognition of disparate national health regulations, together with harmonized labeling, packaging, and additives legislation, will be to encourage firms to operate at a Community-wide level, even if many food markets will continue to be regional. They will be competing with other firms abroad for the same markets, and will have an interest in having access to low-cost sources of supply. This could bring the influence of the food industry to bear on politicians to reduce EC price levels and increase access to imports, but it could also encourage cost-reducing specialization within the EC. So long as the market is national, the processing sector will tend to be aligned with the local production activity. When the market is international, the processing sector will seek to broaden its sources of supply to remain competitive.

Conclusions

The "bottom line" is that the 1992 program is of considerable longrun significance for the Community both in political and economic terms, and will help to shape agricultural policy in ways that may not be apparent at the moment. The CAP will probably not change radically as a direct result of the GATT talks, but they could act as a way of maintaining pressure for reform. If world prices stay firm for a few years, domestic constraints on the CAP could weaken, and the present hesitant steps toward reform could be lost. In those circumstances, a GATT agreement to scale down support could be of considerable value.

This scene will be played out against the backdrop of other events which could have a major impact on the outcome. These include the apparent end to the Cold War, and the enormous implications that would follow a real thaw in economic and political relations between East and Western Europe. Also significant would be the economic impact of a Soviet economy driven by consumer rather than bureaucratic and military decisions. Membership of the Community may also change over the next decade. Austria is preparing a bid for membership, and there are signs that Norway might take up the invitation to join which it declined in 1973. Sweden is concerned about being left out, and Turkey could push its intention to become a full member. In short, the Community could look very different by the end of the century.

Harmonization of the Internal Market and Implications for Intra- and Extra-EC Agricultural Trade

by

David R. Kelch

Introduction

EC 1992 and GATT attempts to harmonize plant and animal health regulations are on a parallel agenda track. GATT negotiations and EC 1992 directives are scheduled to be completed by December 1990, although the EC 1992 schedule for completion of plant and animal health proposed legislation at the EC level is set for December 1989.

The GATT has not been very successful in arbitrating international disputes over agricultural standards regarding plant and animal health. The mid-term GATT agreement in April 1989 included a commitment to settle disputes on international standards by referring to scientific evidence provided by legitimate international institutions.

An important aspect of the EC 1992 program is designed to get rid of nontariff barriers which frequently take the form of health standards. While the two harmonization programs appear complementary in nature, it remains doubtful whether the processes can be successfully linked without interfering with the larger agendas of the EC 1992 program or perhaps even the GATT negotiations.

Before proceeding to the main body of the presentation, it would be useful to acquaint everyone with the key EC institutions that are responsible for the 1992 program.

Key EC Institutions

The **EC Commission** is the executive body of the EC and proposes legislation, implements EC policy, enforces EC treaties, manages the EC budget, and represents the EC in trade negotiations. The Commission has investigative powers and can take legal action against member states and companies. There are 17 Commissioners, two each from France, West Germany, Italy, Spain, and the UK and one each from the remaining member states. The Commissioners are appointed for 4 years by unanimous agreement of the member states and are charged to act in the EC's interest independent of national interest.

The **EC Council** is the EC's legislative body composed of the 12 ministers of the member states and the 12 agricultural ministers when the agricultural agenda is under discussion. The Council acts on Commission proposals and is the final EC decisionmaking body in the EC. The presidency of the Council rotates among member states every 6 months.

The **EC Parliament** is the only directly elected body in the Community and has 518 members elected every 5 years. Its members debate issues, question the Commission and Council, review the budget and propose amendments, and have final budget

approval. It does not legislate but has been given greater power by the 1992 program to influence certain Council decisions.

The **EC Court of Justice** is the EC's Supreme Court. It interprets EC law for national courts and rules on matters pertaining to EC treaties raised by EC institutions, member states, or individuals. Its rulings are binding and it has consistently ruled in favor of EC law in matters of intra-EC trade, thus paving the way for 1992 harmonization.

EC 1992 Background and Update

The goal of the EC 1992 program is to more fully integrate the economies of the 12 member states by eliminating all physical, fiscal, and technical barriers to the free flow of goods, services, capital, and people by the end of 1992. The program began in 1985 with the publication of an EC White Paper which listed 300 directives that, if implemented, would allow the internal borders of the EC to be eliminated.

The Single European Act was passed in 1987 and provided the legislative power to enact the directives required for the 1992 program. The Brussels Summit of 1988 set the end of 1992 as the date for completion of the internal market and provided budgetary support for the 1992 program at the expense of the agriculture portion of the EC budget.

The combined effect of enactment of the 300 directives (100 directives are directed at the processed food and agribusiness sectors) with the elimination of internal EC borders has several implications for EC agriculture:

- o The system of agricultural taxes and subsidies (called monetary compensatory amounts or MCAs) collected at the borders will have to be eliminated, implying price changes for a majority of agricultural products.
- o National quotas and farm support from national treasuries will be called into question either because of administrative difficulty or philosophical differences of principle with the 1992 program.
- o Harmonization of taxes on some agricultural inputs and products.
- o Harmonization of regulations in economic sectors that affect agriculture such as transportation and finance.
- o Harmonization of food safety and plant and animal health regulations.

Of the above, it is the harmonization of standards which has led to widespread fears of a protectionist "fortress Europe." The EC Commission itself cited over 200 nontariff barriers in only a partial survey of the food and drink industry in the five largest EC members.

Obstacles to a GATT Agreement

In agriculture, the fear of "fortress Europe" has been compounded by the EC ban on imports of meat derived from cattle treated with growth promoting hormones, the third-country red meat directive which forced exporters to the EC to retrofit meat processing

plants to exact details specified by the EC, the proposed fourth criterion on which to judge approval of biotechnology products, and by the political priority of the 1992 process. The fourth criterion is the most alarming at this point because it would subject biotechnology products to a nonobjective criterion of social or economic need in addition to the accepted criteria of safety, quality, and efficacy.

The EC 1992 harmonization program uses a deceptively simple methodology which has allowed the political/bureaucratic process to progress at an unexpectedly rapid pace. Countries merely had to agree to minimum essential requirements for health and safety and, when met, the principle of mutual recognition would apply allowing the unimpeded circulation of any legally manufactured product throughout all member states. This methodology would theoretically apply to imports in that once a product was accepted by one EC member, it could move just like internally produced goods. This would create better market access for exports to the EC because only one set of EC standards would have to be met instead of separate and different standards in the 12 member states.

As of June 30, the EC Commission had proposed 74 of the directives related to agriculture of which 48 have been adopted by the Council, leaving about 30 directives which have yet to be tabled by the Commission. The food processing industry will be affected by 32 of the directives and all of these have been approved by the Commission and sent to the Council for adoption. At this point, it would be useful to briefly explain the birth of an EC directive.

After consultations with the affected industry, the appropriate office of the EC Commission drafts a proposal, debates, and approves it. The proposed directive is then sent to the EC Council and the EC Parliament where it is debated and ultimately adopted by the Council or returned to the Commission. Once adopted, the directive is sent to the member state's legislative bodies for implementation.

All of the remaining directives are directed at plant and animal health. The most troublesome of the directives are yet to come and specific limits on animal drug and pesticide residues have yet to be set in the EC including directives approved by the Commission. Examples include tuberculosis, food irradiation, feedstuff additives, and conditions for live poultry.

U.S.-EC Agreement On Limited Role

U.S. concern about the harmonization of standards in the EC prompted an agreement with the EC on formalizing a process whereby the United States could provide input into the EC's standards-setting process. U.S. Secretary of Commerce Mosbacher and the EC's Commissioner for the Internal Market Bangemann initialed the agreement in the spring of 1989 but the agreement covered only industrial products. Since that time, the United States has requested that a similar format be extended to cover agricultural and food products and the EC has been receptive. One of the reasons that agriculture was not included in the original agreement is that industrial standards are set by autonomous committees, whereas, food safety and plant and animal health regulations are formulated by Standing Committees of the EC Commission and Council.

To date there seem to be four fundamental problems with the EC's harmonization of food safety and plant and animal health regulations. The most important involves the interpretation of harmonization and the extension of mutual recognition. It has become clear that different member states will interpret the minimum essential requirements (those that affect consumer health and unfairly impede trade) differently and thus will be reluctant to recognize a different interpretation and product. While the principle of minimum essential requirements is an agreed principle on which to harmonize, certain countries are concerned that quality standards will not be met and local producers will suffer as a consequence.

For example, the French are concerned that brie produced more cheaply in other countries and of an alleged inferior quality will enter the French market and disrupt the French brie market, economically damaging French producers who must adhere to strict national quality controls. A proposal that may prove acceptable is a two-tiered approach where Community assessment based on a single evaluation can be made for new products while mutual recognition with an appeal and binding arbitration system will apply to old products.

Another problem concerns the breakdown in the dialogue between EC scientists and consumers. The hormone scandals in the EC have exacerbated the problem and the secretive nature of decisionmaking in the harmonization process does little to allay consumer's fears. Consumers have no voice in the decisionmaking process and no data are released.

There is no central regulatory body or mechanism in the EC that can provide a single evaluation approach or solve regulatory conflicts. The EC is unlikely to create an equivalent of the U.S. Food and Drug Administration (FDA) in the near future, which leaves the technical component of EC harmonization in a piecemeal bureaucratic dilemma where member states are allowed to diverge from technical opinions. In this context there currently does not appear to be any way that internal trade barriers can be avoided regarding pesticide and drug residue tolerances, for example.

And finally, the political priority of the 1992 program and the commitment to standardize at the strictest possible negotiable level lead many to conclude that exports to the EC may be in jeopardy. The EC has difficulty enough reaching compromises among 12 very contentious and heterogeneous countries and once a common position is reached it is very difficult to change. Third-country concerns are rarely taken into consideration. The strong environmental commitment of many EC governments will not allow them to accept anything but the strictest possible control of health and safety measures. Third countries are concerned that little regard will be afforded EC exporters to the EC.

Implications for Agricultural Trade

The EC's directives related to food and agriculture are most likely to affect trade in processed food and agricultural products. A GATT agreement on a dispute settlement mechanism for sanitary and phytosanitary conflicts could affect the \$146 billion world trade in processed food and agricultural products. The United States shipped \$3.4 billion in high-value products to the EC in 1987 out of a total of \$19 billion in

high-value agricultural exports. The EC exported \$20.8 billion in high-value products in 1987, of which \$2.5 billion went to the United States. The products most likely to be affected are: beef, beef products, animal feeds, specialty fruits and vegetables, and processed food.

The EC is attempting to set internal standards at the highest possible politically negotiable level which could interfere with present trade patterns. Testing and certification for safety and quality of exports to the EC by third country labs will also have to be addressed. However, for those countries able to meet the EC standards and testing and certification procedures, market access would be enhanced because only one set of standards or procedures would have to be met. The United States has high standards and excellent testing and certification procedures and labs and will likely be able to meet most of the 1992 regulations. However, the hormone ban, the red meat directive, and the possibility of having to meet the social and economic need criterion are causes for apprehension.

The hormone ban was not based on scientific evidence and thus seems to contradict what was agreed to at the mid-term GATT agreement on sanitary and phytosanitary regulations. The EC's red meat directive also contravenes the GATT concept of equivalency which is based on equal results without requiring identical methods. The fourth criterion of social and economic need would also fly in the face of the April GATT agreement that called for a criterion of scientific evidence.

On the other hand, if the 1992 program is successful, the United States should enjoy greater access to EC markets as it should only have to meet one standard instead of 12. The United States should thus be able to export more high-value products to the EC. The EC should also become more competitive as food companies that expand to supply the EC market should be able to compete more effectively in the world market. The United States is also well placed within the EC as 12 of the top 20 EC food companies are U.S. owned.

Increased EC demand for food, particularly meat, should also result from higher per capita incomes in the EC. This should be reinforced by movement of investment funds to low wage areas in the Community where the prospects for increased meat consumption are the greatest. The increased demand for meat should allow for lower meat surplus in the EC and less dumping on world markets as well as increase the demand for compound feeds. The United States should benefit through increased shipments of soybeans, corn, and corn gluten feed.

The contradictions are not easily resolved between the way the Europe 1992 harmonization process is going and the midterm GATT agreement on criteria for setting animal and plant health standards. International trade has already been disrupted because of Europe 1992 directives, and, if current trends continue, other disruptions may be on the horizon.

One solution would be to create efficient dispute panels that can speedily resolve the conflicts that will occur among EC member states, as well as conflicts between the EC and its GATT trading partners. Both Europe 1992 and GATT negotiators are considering this alternative and it appears to be a viable alternative. The U.S./Canada Free Trade Agreement recognized this possibility and it appears that both the EC 1992 program and the GATT will move to improved dispute settlement procedures.

CAP Reform and 1992: A German Perspective

by

Wilhelm Henrichsmeyer

Introduction

For a long time, the Common Agricultural Policy (CAP) has been a prototype of an inward looking, highly protectionist agricultural policy. During recent years, the economic and political environment for decisionmaking in the CAP has changed significantly due to several factors such as escalation of budget expenditures, conflicts with trade partners, opposition of environmentalists, and increasing income pressure in agriculture. Furthermore, the progress toward the Single Market 1992 has changed the overall political climate, and the GATT negotiations may limit the scope of political action.

As a result, the process of agricultural policy formation has become more complex, and some remarkable policy decisions have been made. But the opinions differ with respect to the nature and significance of those changes.

I have been asked to comment on the past developments and future perspectives of the CAP from a "German perspective." However, I have to say right at the beginning that these comments might be rather different if you would have asked another colleague from the academic world in Germany. I belong to those who are convinced that remarkable changes of the CAP have taken place during the last years. The main concern is whether it will be possible to continue the new policy orientation for a longer period of time. In my view, it would be misleading to expect that a "great policy reform" will be proclaimed some day. The reform of the CAP will be a continuous process. First steps are already underway, even if this has not been realized by many observers.

I am surprised that this view is shared by the other colleagues on this desk, since many academics in the EC and the United States take a different position. They believe that the CAP is a creation of the devil and will never change. I have asked myself how this biased selection of speakers for this meeting could happen, and came up with the hypothesis that those who do policy-relevant research work and stay in dialogue with policymakers are able to detect changes, while those who read only publications and write new ones on that base, belong to the more skeptical category.

It is against this background that I will present in the following a more differentiated view on the past performance of the CAP, and will base on that some considerations on the determining factors and the future perspectives of the CAP.

Past Performance of the CAP

The performance of the CAP has not been as uniform as it is often assumed. A closer examination reveals that some significant policy changes have occurred in the course of time. Four phases can be distinguished (Henrichsmeyer, 1989).

1960-78

The first phase (1960-78) was characterized by an "income-oriented" price policy. Already at the outset, the EC member states agreed upon a rather high level of agricultural prices to satisfy income needs in those member states with a tradition of high agricultural protection and less favorable production conditions. Also, in the course of time, the changes of administered prices were mainly determined by agricultural income goals. More specifically, an "objective method" was used by the EC Commission to calculate price increases according to nonagricultural income development and cost rises. Often, the resulting price proposals were corrected upward by the Council of Ministers in order to satisfy specific national income goals. As a result, average agricultural per capita income in the EC increased roughly at the same rate as general income during this period. Under the prevailing rates of technical progress and structural change in agriculture, this was realized at slightly decreasing agricultural prices in real terms (around -1 percent).

This income-oriented price policy was complemented by a set of structural policy measures which included, on the one hand, support of farm growth and, on the other hand, incentives for labor mobility and the closure of agricultural holdings. In this phase, the annual rate of outmigration of agricultural labor amounted to about 3-4 percent in the EC. To avoid too rapid and far-reaching adjustments in "less favored areas," a specific income support program for these regions was conceived.

Under the umbrella of this policy setting, EC agriculture realized high rates of technical progress and production expansion. Overall agricultural production increased by 2 percent annually, compared to a demand growth of below 1 percent. The result was a stepwise closing up of import gaps and increasing surpluses on agricultural markets. During this phase, the average degree of self-sufficiency within the EC rose from 85 percent to about 100 percent. As a consequence, expenditures for agricultural market interventions started to increase dramatically.

1979-84

During the subsequent phase (from 1979-84), the awareness of unavoidable policy changes increased, but action was taken only reluctantly. The EC Commission proclaimed the need for a more "cautious" price policy, and the Council had no alternative but to follow this line under the pressure of budget constraints. After a few years, however, the resulting pressure on agricultural income, and a temporary relaxation of the budget squeeze, due to high world market prices and a strong U.S. dollar, led again to price "corrections." During this period of "stop and go," no clear signals and incentives for agricultural producers were set, resulting in a continuation of production increases and escalation of budget expenditures.

In this period, agricultural incomes came under pressure and the disparity to other sectors of the economy increased. This situation was more a result of a slowing down of outmigration and a lack of structural adjustments in agriculture in response to unfavorable employment opportunities than the consequence of a restrictive price policy. In West Germany, for example, the rate of labor force reduction in agriculture fell from 4-5 percent in the 1960s and early 1970s to less than 2 percent by the end of the 1970s. In the domain of structural and socially oriented policies, there was a shift toward less

production-stimulating measures. Instead of specific investment aid for "farm growth," more emphasis was placed on general income support. Moreover, direct payments and compensations in connection with environmental measures were implemented in some of the member states.

1984

Escalating budget expenditures necessitated more fundamental changes of the CAP in 1984. The most diverse opinions existed between the member states on the principal question of whether the necessary reduction of production growth should be brought about by price reductions or direct quantity controls. Following a long series of negotiations, including summits of the Heads of State, the Council agreed on the introduction of production quotas for the milk sector and a more market-oriented price policy concerning other commodities, especially grains. Contrary to the expectations of most agricultural economists, milk quotas were enforced rather strictly, such that the surpluses of milk products could be stepwise reduced. The restrictive price policy for other commodities has, so far, only little effect on production growth, but has contributed to the pressure on agricultural income.

1988

The Council decisions of February 1988 marked the beginning of a fourth phase. For the first time, it agreed upon a definite budget ceiling for agricultural expenditures and automatic price reductions if production exceeds certain thresholds ("stabilizer mechanisms"). It is especially remarkable that these decisions refer to a medium-term period of 5 years. Hereby, the Council considerably limited its scope for action in the field of price policy.

Besides these basic decisions on the price side, the Council agreement includes a package of complementary structural adjustment measures. In addition, principal agreement was reached concerning an EC program on direct income payments, but this still needs to be specified.

The most important message of the 1988 Council decision is that the principal decision for a market-oriented price policy (besides milk and sugar) has been confirmed and strengthened. This is done in two ways:

- o Through the introduction of production thresholds and "stabilizer mechanisms," in particular for grains and oilseeds. If the thresholds are exceeded (which has to be expected in the case of "normal" harvests for many years), prices will be reduced automatically by 3 percent per year (for grains) or according to the percentage of excess production (for oilseeds).
- o Through the introduction of a budget ceiling for agricultural expenditures. This ceiling ensures that the rate of increase for agricultural expenditures must not exceed 74 percent of the growth rate in the overall EC budget. This will limit the space for action in the yearly price negotiations, and will exert additional pressure on "loosening" the intervention rules (higher quality standards, only periodic interventions etc.) which had already had an important impact on the level of average producer prices.

The package of 1988 decisions includes further complementary measures to support factor and supply adjustments and to mitigate income pressure and hardship of structural change. These measures include:

- o Financial incentives for idling agricultural land (set-aside program).
- o Subsidies for the conversion or highly extensive use of agricultural land (e.g. afforestation or use for ecological purposes).
- o Payments for early retirement of farmers (beyond age 55).

In addition to these newly created measures and programs, many "old" EC measures still exist. The most important are:

- o The quota systems for the milk and sugar sectors.
- o A special support program for "less favored areas."
- o A modified "farm modernization" program which has become less selective and rests mainly on rather broad investment subsidies.

Besides these EC-conceived programs, many agricultural policy measures exist on the national as well as on the state and regional levels. These comprise mainly subsidies for the social security system, environmental measures of different kinds, and income payments for various purposes.

Future Needs

Despite the changing strategies of policy intervention, overall agricultural production has grown rather continuously in the EC. In the following, the sources of this production growth will be sketched shortly in order to reach a better understanding of the needs for factor adjustment and structural change in EC agriculture, as well as of the difficult policy tasks for the years ahead (Henrichsmeyer and Ostermeyer- Schloder, 1988).

Trends of Productivity Growth

Over the last three decades, the output of EC agriculture has grown more than twice as much as domestic demand. In the 1960s and early 1970s, this led to a closing up of import gaps, and later to rapidly increasing surpluses on most agricultural markets with the consequence of an escalation of budget expenditures and conflicts with trade partners. From 1965 to 1985, total agricultural production increased in the EC by more than 40 percent which corresponds to an average yearly growth rate of nearly 2 percent. The rates vary markedly between the EC member states, from 1.5 percent in Italy to more than 4 percent in the Netherlands.

On the input side, the following characteristic changes have been observed during 1965-85:

- o Intermediate and capital inputs increased continuously, overall intermediate input at about the same rate as total agricultural production and overall capital input at a

somewhat larger rate. However, during the last decade, the growth of the capital stock slackened off, because investments in buildings and machinery were reduced drastically, an obvious result of the more restrictive price policy and of the deterioration of the agricultural income situation.

- o Labor input in EC agriculture decreased rather rapidly over the whole period, at an average rate of about 3 percent. However, the last decade experienced a much smaller decrease than the preceding decades, as a consequence of the unfavorable general unemployment situation.
- o Total agricultural acreage declined slightly in the EC by 0.3 percent. Total factor input has been virtually stagnant in EC agriculture, which means that nearly the whole production increase has to be attributed to the growth of productivity. Over the last three decades, the growth rate of global productivity was 1.7 percent in the EC. But, in the course of time, this rate had decreased stepwise from 2.4 percent in the 1960s to 1.3 percent during the first half of the 1980s. This is mainly the result of a more moderate labor migration.

Needs for Factor Adjustment

The central challenge for the CAP is to bring production growth better in line with domestic demand development in order to avoid a further accumulation of surpluses and to limit the extension of budget expenditures. The necessary reduction of agricultural production growth will have far-reaching consequences for factor allocation and production structures in EC agriculture.

If we assume that the present degree of self-sufficiency (the volume of surpluses) should not increase further, then the growth rate of total agricultural production would have to be reduced by about 1.4 percent. This means that production growth would have to be reduced by nearly one-half compared to the one-third reduction of the past decade. If we assume further that the growth rates of factor productivities will not change (as a preliminary working hypothesis), then the following adjustments of factor capacities would have to be brought about:

- o Labor input would have to be reduced by more than 4 percent. This has to be seen against the background of an average reduction rate of 3 percent over the last three decades, and a much lower rate during the last decade. That means that the migration rate would have to be increased by more than 50 percent compared to the present situation.
- o Agricultural acreage would have to be reduced, in addition to the present trend, by more than 15 percent in each decade.
- o The growth rate of intermediate input use and capital input would have to be halved compared with the trends of the past; this process is already underway for capital inputs.

These considerations and rough estimations have to be modified according to possible changes of productivity growth and factor substitutions (Henrichsmeyer and Ostermeyer-Schloder, 1988, p. 148). With respect to productivity growth, neither empirical analyses nor the judgment of scientists in the area of biotechnical research

indicate that the continuous stream of technical progress will slow down during the next decade. The slower growth of total factor productivity during the last decade seems to be determined more by less efficient factor use (hidden unemployment in agriculture, milk quotas) than by slower growth of the technological potential. Environmental restrictions might reduce the production growth in the EC in the longer term, but probably not to a larger extent within the next decade.

After having discussed possible magnitudes of necessary factor adjustments, it has to be asked in which proportions the different categories of input factors should be reduced. General considerations on optimal resource allocation lead to the conclusion that it would be advantageous to reduce mainly the input of those production factors which can be profitably transferred to other sectors of the economy. These are mainly industrially produced intermediate inputs and capital, as well as those members of the labor force who have alternative employment opportunities.

At first glance, a reduction of yield-increasing intermediate inputs such as fertilizers and pesticides appears to be an appropriate starting point for reducing production growth. This could have an immediate and significant output effect. But because of the high marginal productivities of these inputs, heavy political measures would be necessary. These could be either direct quantity restrictions or drastic economic disincentives. Calculations on the basis of production functions for yield-increasing inputs show that, for example, a tax on nitrogen of about 400 to 500 percent would be necessary to achieve a noticeable reduction in yield-increase. Although such measures are often favored because of their assumed positive impact on the environment, a broader application is not to be expected, at least not in the near future (because of loss of efficiency, artificial deterioration of the competitive position on the world market, etc.).

This has important consequences: if the intensity of production per hectare cannot be influenced noticeably -- at least in the short and medium term -- then land and yield-increasing inputs have to be considered as linear-limitational factor combinations. This means that the reduction of crop production must be obtained by a reduction of the whole package, which implies idling of (marginal) agricultural land.

A faster reduction of the labor force and corresponding structural changes in the farming sector will have -- under the prevailing conditions of small-scale farming in EC agriculture -- only little impact on yields and production. Even yield increases can be expected if more efficient farmers take over the abandoned land. However, labor migration is of crucial importance for longer term supply adjustments because larger farm sizes and new socioeconomic types of farming (part-time farming, multiple jobholding) may allow for more extensive forms of low-input farming.

In summary, in the short and medium term, some inflexibilities limit the adjustment possibilities of agricultural production. This is especially true for land use, where changed relative factor scarcities call for less intensive forms of production, while the existing technologies (shape of production functions) and farm size structures tend to favor high-input/high-yield production. In the long run, the reduction of the agricultural labor force and the creation of efficient farm structures are the most important tasks of the future. This is also a precondition for less intensive production systems and supply adjustments.

Agricultural Policy Formation in Germany and the EC

Agricultural policymaking in the EC has specific features and complications because of interactions between the national and EC levels. The basic policy discussions take place at the national level in the different member states; the decisions are made in a political bargaining process in the Council of Ministers (Petit et al. 1987). Germany plays a rather important role in this process because of the structural problems of German agriculture and a rather strong political position of agricultural interest groups. German Ministers of Agriculture have always been reluctant to agree to a more market-oriented price policy and other steps of CAP reform. Therefore, it might be rewarding to have a closer look at the German position in the current reform process.

In the crucial area of price policy, it is astonishing that the German Minister of Agriculture, backed by the Chancellor and the Cabinet, accepted the February 1988 Council decision on stabilizer mechanisms which implies a series of perceptible nominal price reductions for grains, oilseeds, etc. for a 5-year period. This has to be seen in contrast to his isolated veto-position in the Council to a marginal grain price reduction a few years before. However, this should not be (mis-)interpreted as a conscious political move to adopt the principles of a market economy, but rather as a response to unavoidable constraints and politically more damaging alternatives (a comprehensive system of direct state interventions).

In the field of income policy, one can observe a stepwise move of the government toward a weaker formulation of income goals. The initial goal of "income parity" was modified rather early to the goal of reaching the similar rates of income growth as in the general economy (at a given degree of disparity). During the last decade of increasing income pressure, parity has been further weakened. Now it means mainly avoidance of unacceptable income pressure for "problem groups" in the farming sector. Correspondingly, there has been a stepwise shift toward direct income payments. In this context, a "silent" move in the position of the Farmers Union is of interest. For decades, it has opposed direct income transfers; but after the prices for agricultural commodities have declined and are expected to decline further, the Farmers Union has begun to press for income transfer of all possible kinds. However, this attitude does not mean that the principle of decoupling has been adopted, rather it is one of the remaining alternatives for rent seeking.

These changes in price and income policies also have consequences for attitudes toward change in agriculture and structural policy. Now it is broadly accepted that a continuation and acceleration of structural change, including part-time farming, is unavoidable. Also, the farmers themselves have reacted: the rate of outmigration of farm labor has increased considerably during the last years.

The concern about the environmental problems connected with high-tech farming and about the future of the rural landscape is growing, and gaining increasing political relevance. The measures proposed tend in two directions: restrictions on high input farming and large-scale animal holding, on the one hand, and incentives for low input farming systems and the protection of landscape, on the other hand. The general public support for measures of this type is strong, and the policymakers on the different levels are eager to be viewed as taking action. But, so far, it is uncertain whether and when these measures will have a significant impact on the overall development of agricultural

production. The agricultural interest groups, including the German Minister of Agriculture, try to limit the restrictions on agriculture and to use ecologically motivated measures as vehicles for income transfers.

On the whole, the remarkable policy changes of the last years seem to be more the result of stronger constraints (budget, trade conflicts) and new challenges (environmental problems) than of a principal shift in the goals of the political actors in the process of agricultural policy formation.

Future Prospects of the CAP

The reduction of production growth and of agricultural budget expenditures is a necessity. This internal pressure is the most important driving force for changes of the CAP. Further influencing factors are measures in connection with the completion of the Internal Market in 1992, and the ongoing GATT negotiations.

Possible Impact of Completing the Internal Market and the GATT Negotiations

The completion of the Internal Market is an important step in the overall process of economic and political integration in the EC. However, it has to be realized that the Common Agricultural Policy and the Common Market for agricultural commodities have existed for three decades. The creation of the Internal Market means therefore, in the case of agriculture, only an additional step toward more intensive intra-EC competition by the removal of technical trade barriers, the harmonization of quality standards, adjustments of indirect taxes, perfection of the transportation system, and dismantling of restraints to factor mobility (Kelch, 1989).

Most of these measures directly concern the food industry and agribusiness, but changes in the scale and regional distribution of these enterprises will have significant indirect impacts on agriculture. Further, the possibility for special national arrangements, especially those in connection with revaluations or devaluations of EC currencies, will be limited. On the whole, the completion of the Internal Market will have significant impacts on EC agriculture, but the internal pressures, mentioned before, will be the more decisive forces for CAP changes.

This conclusion also seems to be true with respect to the GATT negotiations. Internally, the EC is obliged to pursue a more restrictive price policy in order to dampen the increase of surpluses and budget expenditures. In the medium term, it can be expected that real price reductions for agricultural commodities will be larger in the EC than on the world markets. According to modelling calculations, the rate of protection in the EC grain sector might be halved during the next decade (Wissenschaftlicher Beirat-- Scientific Advisory Board --, 1987). If this happens, then the internal pressure for EC price reductions might be larger than the willingness of other trade partners to reduce their agricultural protection.

Alternatives of Price Policy and Their Consequences

The strategy of price policy is of crucial importance for the further development of the CAP as well as for the significance and effectiveness of many structural and social policy measures. More specifically, the central question is what degree of price reduction

should be envisaged for the next decade: on the one hand, in order to stimulate factor adjustments and supply reactions, on the other hand in order to avoid intolerable income problems, including liquidity problems in efficient farms. The discussion of this question is based on the results of various modelling exercises for the EC and individual member states (Henrichsmeyer, et al, 1985; Braune and Henrichsmeyer, 1988).

The Main Results Can be Summarized as Follows

Very drastic price cuts would be necessary in order to bring production in the short and medium term in line with demand by price policy alone. The necessary real price reductions for cereals and competitive crops would be in the range of 30 to 40 percent over the next 5 years. To avoid social hardships, huge amounts of direct income transfers would be necessary, which seems to be neither economically reasonable nor politically acceptable.

On the other hand, a return to the income-oriented price policy of the past would lead almost inevitably to a further increase of direct state interventions (quota regulations, obligatory fallow etc.). In the event, indirect economic incentives such as premiums for conversion or set-aside would lead to a prohibitive escalation of budget expenditures.

Therefore, good reasons support the strategy of a "medium line" of price policy, which is based on significant, but not extreme, price reductions, and which also includes economic incentives to accelerate factor reductions (land, labor) as complementary measures. According to economic modelling results, a reduction in real prices for nonquota commodities of about 20 to 30 percent over the next 5 years would lead to a significant decline of land rents. This means that a conversion of agricultural land to other uses could be brought about by reduced additional economic incentives (premiums). With respect to income development, the model calculations show that the real per capita income in agriculture could be maintained if the rate of outmigration of labor and the speed of structural change in the farming sector would approach again the magnitudes of the 1960s and early 1970s which were realized under favorable general employment conditions.

On the basis of considerations and calculations of this kind, for example, the Scientific Advisory Board to the German Minister of Agriculture recommended a distinct and steady, but not drastic, reduction of the level of agricultural price support, supplemented by additional structural and social measures (Wissenschaftlicher Beirat --Scientific Advisory Board--, 1987 and 1989).

According to the observed price developments during the last years, actual EC price policy is roughly in line with such recommendations. However, the question is whether the EC Commission and the Council of Ministers will be able to continue this restrictive price policy, if the income pressure grows further.

Limited Impact of Set-Aside Program on Production and Market Development

The Council decision of February 1988 also includes the introduction of new programs which offer incentives for idling of agricultural land (set-aside program) and for less intensive cultivation (extensification program). These measures could be conceived, theoretically, as major instruments of supply control, or even as an alternative to a

restrictive price policy. A closer analysis, however, reveals that they can be considered only as complementary measures to a restrictive price policy.

If the EC would return to an "active" price policy, yield growth on the remaining land would continue. Then, year by year, an additional 2 percent of the agricultural land would have to be set aside. This would mean that in the course of time a dual system of land use would evolve: highly subsidized "nonuse" of agricultural land on a steadily increasing area, on the one hand, and highly intensive farming on the remaining land on the other hand. This would have many serious disadvantages; among them are:

- o It would be inefficient; the environmental problems of intensive farming would be aggravated.
- o Landownership, property rights, and income distribution would be affected.

Moreover, such a policy would become increasingly more costly for the EC budget because, at high land rents, high subsidies would be necessary to "buy out" increasing amounts of agricultural land going into the set-aside program. If no other argument would be relevant in the political process, this will be the lever to bring agricultural prices and land prices down.

Only in the case of compulsory set-aside measures would the need for a more market-oriented price policy and lower land rents be reduced. But this would mean the introduction of direct quantity regulations with all its manifold difficulties and problems, especially under the structural conditions of the EC. Therefore, their realization is not probable, but cannot be excluded as a last resort.

Increasing Importance of Income Policy

The importance of direct income transfers has gradually increased in the EC. So far, the measures have been mainly related to either specific situations (compensation for sudden price adjustments in the case of revaluations or devaluations of national currencies) or specific regions ("less favored areas"). At present, an EC program on income aid according to socio-economic criteria is in preparation. Principally, a distinction should be made between the following two motivations for direct income payments to farmers:

- o Compensation for structurally or socially caused hardships.
- o Remuneration for the provision of public goods and services.

Compensation payments of the first kind have been made on several occasions. Their importance will likely increase as a means to find compromises in the yearly EC price negotiations. However, compensations of this type can be justified only as transitional measures for a medium-term period, e.g., for the present generation of farmers.

Specific measures for the provision of public goods and services, e.g., the preservation of nature and environment, or the social stabilization of rural areas, have had only limited relevance so far. The need for those measures will likely increase. However, payments of this kind should be very specific in order to reach the desired goals and they will have

to be based upon appropriate criteria. In this case, direct income payments can have a long-term justification.

Most of the present income support measures in the EC are not sufficiently goal-specific. They often give wrong signals to producers, and consequently retard desirable structural adjustments. If direct income payments are going to expand, a more goal-specific orientation of these measures is an important task in the context of CAP reform.

Possible Impact of Environmental Measures

There can be no doubt that the awareness of environmental problems in connection with intensive forms of agriculture will further increase, and will affect policymaking. At present, many "soft" measures (information, extension, low-dimensioned economic incentives) and rather narrow limited "hard" measures (limitation of the use of fertilizer and pesticides in water reservation areas) are being applied. The central question with regard to future production growth is however, whether the environmental problems will escalate to such a degree that drastic restrictions become necessary in large areas or even in the EC as a whole.

In this respect, the first candidate for "hard" measures might be water pollution by nitrogen and pesticides. High taxes or quotas for fertilizer, and prohibition of risky pesticides have been proposed. If such measures would be taken, this could have a significant impact on production growth and world agricultural trade. But this is not to be expected in the near future, and probably not within the next decade.

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The CAP and 1992: A French Point of View

by

Yves Leon and Louis P. Mahe

Introduction

Events occurring since the early 1980s, both on the world scene and in Europe itself, have largely altered the economic and political landscape around the Common Agricultural Policy (CAP).

On the world scene, depressed prices of agricultural products have resulted from the sluggish demand due to the slow economic growth and the burden of the foreign debt in traditionally importing countries. Meanwhile, agricultural capacity in rich countries has not been adjusted downward fast enough to cope with the imbalance between demand and productivity trends. Because of inflation in costs and weak prices, farm incomes have suffered. A strong international activity to reassess agricultural trade policies in rich countries has developed, which culminates now in the GATT round of negotiations. The farm policy of Europe is still the target of criticisms from the main exporters and is under pressure to reduce the level of support provided to farmers.

Within Europe also, new circumstances have appeared which call for a significant reform of the CAP. Surpluses in most community markets and the related expenditures of the European Guarantee and Guidance Fund (FEOGA) have made the need for change more obvious to many.

But agricultural problems are not the only source of pressure for the CAP to adjust to new times. The prospect of the Single Market and the "relance européenne" has revitalized faith in European integration, and has also brought new blood to European affairs. The CAP, long viewed for its Community-unifying role, has become somewhat outdated under these circumstances. It is bound to change as both its means and principles have ceased to be considered untouchable dogma.

In this paper, we argue that the CAP has already made some significant changes over the past few years in response to the new circumstances. But we also point out that some basic problems of European agriculture are still unresolved, and that the supranational nature of the CAP and history constrain the margin of maneuver into narrow bounds.

We turn next to the expectations of France from the CAP and its role in the European farm policies. This view is largely critical in that it can be argued that our country has not really played the cards of comparative advantage in the earlier period of the Green Europe. However, there are some tentative explanations for that to have occurred, but some changes have now become unavoidable.

In the last section, we briefly review the prospects of 1992 and other circumstances, including environmental problems, for the future developments of the CAP. We conclude that, however hard it might be to justify on some economic grounds, the CAP

is not so different in many respects from most developed country farm policies faced with similar circumstances.

The New CAP Has Arrived

Every year by early winter, the wine growers of the Beaujolais area in France launch an advertising campaign which spreads like a rumor over Europe: the slogan "The new Beaujolais has arrived." Every year as well by early spring the price negotiations ritual takes place in Brussels and is the occasion to discuss policy changes often coined "reform" of the CAP. The CAP has been continuously reformed since its inception, but one may question how deep and serious can be a reform which comes every year or so like Beaujolais.

The New Vintages of the 1980's¹

Starting from the early 1980s however, the need for and the will to reform has gained momentum, and it is fair to say that the vintages from 1984 to 1988 are a bit special.

The dairy quota first turned out to be a major decision, even if, as economists, we do not like this type of policy instrument. This system was obviously the only way to stop the explosion of milk surpluses without bearing the political cost of cutting prices. Incomes have been preserved, particularly for those now in production who benefit from sizeable quota rights. The newcomers and the next generation will not benefit, but they, like consumers, had little to say in the decision process. In terms of market balance and of stock disposal, the quota system has been quite effective. Deliveries have declined from 99 million tons in 1984 to 94 in 1988 (table 1). Meanwhile public stocks of butter and powder have been drastically reduced. These new measures have brought with them significant budget savings, particularly on intervention measures in spite of the cost of disposing of "old stocks."

The will to cut dairy surpluses has been confirmed by further reductions of the dairy quota from 99.4 million tons in 1984-85 to 91.0 million in 1988-89. Penalties for exceeding quota references are now more strictly applied than in the early years of the program. Altogether, the dairy quotas have brought deep changes in the European farm sector, and casual estimates of the equivalent producer price cuts run around 20-25 percent in real terms (Guyomard and others, 1988).

The significant impact of the EC dairy quota can now be observed in both the domestic and world markets for dairy products. Butter production in 1988 was down by 20 percent relative to 1983, the last year of the pre-quota era. Butter stocks have also decreased drastically, partly due to special programs of old stocks disposal and also to the fall in purchases which declined by 8 percent in the first half of 1988 as compared to the same period of 1987. Butter prices have moved up on the domestic market reaching the intervention price (rather than being 8 percent below in 1987). Similar changes have occurred with skim milk powder. Skim milk powder prices were even 25 percent above intervention prices (CCE-- EC Commission--, 1989). The tension in the domestic market is partly due to the expanding demand for manufactured fresh dairy products,

¹Figures quoted in this section come from CCE -- EC Commission-- (1989).

and partly to the world situation where prices have increased by 20-50 percent for butter, and 50-100 percent for skim milk powder.

At the Brussels European Council in February 1988, several restrictive measures were taken. The "budget discipline" now imposes a ceiling on the increase of FEOGA expenditures for market support at 74 percent of the GDP growth rate. This is far less than the average increase from 1980 to 1987 (about 2 percent in real term under current GDP growth rate, versus 6 percent). The actual way to make it work, however, is to have price decisions and accompanying measures to help reduce market imbalances. The budget stabilizers have given more power to the Commission to do that, as objective ceilings on production in excess supply are now specified. The Maximum Guaranteed Quantities (MGQ) have already become effective in several sectors although, as they were decided after plantings of the 1988 crop, the full effect remains to be seen.

For grains, the 1988 crop (162.5 million tons) overshot the MGQ (160 million tons) and a levy of 1.6 percent was withheld from producers. In the price decisions for the crop year 1988-89, the producer price was cut by 3 percent as a result of the application of stabilizers. This is done through a co-responsibility provision which can be revised after the actual crop level is known. For grains, the productivity trends are expected to make production hit the ceiling in any normal year. If prices in ECU are decreased by 3 percent as expected, it is a price cut of about 6 percent per year in real terms at the producer level that can be implemented by the Commission. These changes are potentially able to control grain surpluses.

Another clear-cut example of the capability of the budget stabilizers system to reduce production incentives is found in the oilseed sector. For rapeseed as an example, prices were reduced by 10 percent for the 1987 crop and 7.6 percent for 1988. The limit of 10 percent which existed on the price cut was also removed, making the system potentially more severe for the coming year. For sunflower, the price cut in 1988 was 19.8 percent. On the basis of the last couple of years, it is hard to maintain that budget stabilizers have not brought any real change.

The adjustment through support price cuts and budget stabilizers has also been complemented in the 1989-90 price decisions by lowering the safety net of "intervention." More exactly, the EC Commission has clearly expressed the will to restore the role of public storage as a safety net rather than a normal outlet. Commodities are to be purchased by the public storage agencies at a price lower than intervention price, and permanent intervention was abandoned in favor of shorter periods during the crop year (the intervention period for grains was cut by 1 month at the last price decisions).

Even if some colleagues from Europe and in several quarters of the world express doubts about stabilizers, we think that it is fair to say that over the past few years the EC has done quite a bit to impose a clear limitation on the usual system of open-ended price support policies, as can be seen in table 2 where prices in real terms have decreased noticeably and much more than in the past in the grain sector.

Table 1--Effects of dairy quota on the domestic and international markets

Commodity	1980	1983	1984-85	1985-86	1986-87	1987-88	1988-89
Milk deliveries (1,000 t)	95,751	103,635	99,113	99,900	100,100	94,240	--
Quotas 1/ (1,000 t)	--	--	99,440	98,970	99,260	93,450	90,993
Dairy cows 1/ (1,000 heads)	25,520	25,363	25,765	25,043	24,303	23,868	22,491
Public stocks (1,000 t):							
Butter	147	686	973	1,018	1,297	888	--
Skim milk powder	231	957	773	514	847	594	--
International prices: 2/ (\$/ton):							
Butter	--	1,800	1,300	950	1,050	750	1,150
Skim milk powder	--	780	640	600	680	760	1,150

-- = Not available or not applicable.

1/ EC 10; Source: EC Commission, *The Agricultural Situation in the Community*, various issues.

2/ Quotation is the lower end of bracket, FOB North European and selected world ports; Source: U.S. Dept. Agr., For. Agr. Serv., *World Dairy Situation*. FDS, Nov. 1988.

Which Forces Move the CAP Now

The CAP has a long tradition of high support prices. Before the significant changes mentioned above, some relatively minor adjustments were made in the past in response to domestic pressures (farm incomes, budget) as well as international changes (world prices).

There is now in the EC a completely new situation generated by the reversal of the trade balance for most temperate zone product commodities. After milk, grains are now in permanent excess supply, and marginal production has to be exported. The gap between domestic and world prices must be met by export restitutions; thus, all the additional cost of farm price support is now borne by the budget.

The self-sufficiency tends to spread over the whole sector as resources freed by the surplus commodities (dairy, grains), as a result of explicit or implicit price cuts, are moved to the remaining relatively uncontrolled products (oilseeds, other protein crops, beef). A permanent excess supply for beef is to be expected in the long run after the negative effects of the dairy quota are exhausted. This is already the case for oilseeds and other protein crops which substitute easily for grains. The budget consequences in the case of oilseeds are huge because, as in the U.S. case for grains, the support is provided through deficiency payments, and expenditures become highly sensitive to quantities supplied and to world prices. FEOGA spending on oilseeds has soared dramatically over the last few years.

The immediate effect of product expansion on budget costs has changed the economic and political environment of policymaking within the Council of Ministers. The additional costs of the CAP are no longer hidden in the consumer losses of real income as they are visible on the records of the public budget. This new situation introduces a feedback mechanism leading to a continuous reassessment of the economic and political basis for continued price support policies. These countervailing forces are amplified by

the implications of the financial solidarity principle which puts a burden on the less "agricultural" and net importing (or now rather, less exporting) countries. It is commonplace to see the United Kingdom, and increasingly, Germany, advocating budget-savings.

Table 2--Annual changes in farm prices in real terms

Commodity	1985-75 (3)	1982-81 (1)	1983-82 (1)	1984-83 (1)	1985-84 (1)	1986-85 (2)	1987-86 (4)	1988-87 (4)
<u>Percent</u>								
Total	-2.4	-0.2	-2.7	-3.1	-4.2	-3.6	-4.5	-1.7
Vegetables	-2.1	-.4	-.8	-3.9	-5.4	-1.7	-4.6	-3.3
Cereals	-3.2	-1.6	-.7	-6.9	-9.0	-2.8	-5.9	-7.3
Animal products	-2.7	-.1	-4.3	-2.5	-3.3	-5.1	-4.5	-.4
Beef	-3.1	1.2	-4.8	-5.7	-4.5	-6.7	-2.5	-3.2
Dairy	-1.9	1.1	-.7	-4.1	-1.0	-.7	-2.5	+2.4

1/ Eurostat, Semester Statistics, 1, 1987. 2/ Agricultural Situation, 1988.

3/ id., 1987. 4/ Eurostat, Statistiques Rapides, 1989, 12, p. 15.

Budget costs are not the only force acting in favor of revision, however. The lack of markets for subsidized exports (particularly dairy products), the transfer of the benefits to foreign consumers (Eastern Block purchases of cheap butter) and, more generally, the perceived waste of goods from excessively long public storage,² have also contributed to undermine the strength of traditional advocates of continued and unlimited support.

An active international activity has developed in the GATT and other circles increasing the foreign pressure on the CAP. But it is our belief that these foreign forces, however strong, have limited impact compared to domestic forces. In some occasions they may even backfire as they give some "ad hoc" nationalist arguments to the group who fights to defend "our national trade interest," whoever actually benefits from current policies eventually. Conversely, the argument that foreign producers are also adjusting to new times is a useful way to help convincing domestic farm organizations that changes are to be made everywhere.

The changes mentioned above are not to be regarded as negligible as we argued. However, they should not lead us to forget the basic problems of European agriculture which makes bold policy adjustments difficult to achieve, and particularly so in the context of a supranational organization where national second thoughts are the rule rather than the exception.

The European Agricultural Problem

The CAP has long been criticized on economic grounds, and we think there is some basis for that. But the challenge of achieving European integration in a declining industry was not a small one. The example of the steel industry in Europe and in the

²The Commission decision to include the corresponding cost to the budget of the current year means a clear change in attitude with respect to intervention.

United States shows that hard policy choices are costly to make. The fiber and textile industries in rich countries provide another example of national attitudes trying to escape the implication of changing comparative advantage in the world. European agriculture is no exception to that, and the situation is made even more complex by the heterogeneity of European agriculture, which the recent enlargement has markedly increased.

In the original EC-6, the agricultural problem was not too heterogeneous in the sense that protectionist policies had been the rule since the late 19th century in the larger countries (Germany, France, and to some extent Italy). The famous Franco-German compromise, also called the wedding contract, that is, French farm exports in exchange for German industrial products, was not so hard to reach. Prices were set at a high level, particularly upon insistence of German producers. Countries like Belgium and Netherlands who had opened their agriculture to world influence were able to adjust as their agricultures were efficient, open to trade, and oriented toward animal products which also benefited from the common market organizations. As a consequence, they were less penalized by the high grain policy, and even less so as their compound-feed industry developed rapidly on cheap imported feed ingredients thanks to the bound tariffs on nongrain feedstuffs.

The first enlargement created a new situation with the membership of the United Kingdom, a large country, traditionally low-cost importer of food, but with a modern agricultural sector, whose capacity had been clearly underestimated³ (the self-sufficiency rate in the United Kingdom has moved from 65 percent in 1970-74 to 140 percent in 1985 for grains and from 18 to 73 percent in butter).

At least two conflicting views on agricultural policy were constantly opposing each other in Europe: the British complaining about the cost of the CAP for Britain and arguing for lower support and the French and Germans pushing for price increases qualified as "sufficient" to maintain farm incomes. The conflict has now become less tense after the solution of the so-called British contribution problem in 1984 (an issue which should fade somewhat anyway with the rapidly increasing rate of self-sufficiency in the United Kingdom). Meanwhile the MCAs have also provided some flexibility in the CAP and allowed Germany to have higher domestic prices than its partners.

The second enlargement to the south (Spain and Portugal) has further increased the heterogeneity in European agriculture in the opposite direction of smaller, less efficient, and low-income farmers. This in itself prevents a drastic shift toward direct income payments as the needs are in the south and the resources in the north, and the solidarity principles, even if celebrated in words, will rapidly reach their limits.

Because of the predominance of small farms in much of Europe, it is both politically and economically difficult to speed resource adjustment by pressing prices and therefore incomes downward. Because of the heterogeneity of the European agricultural sector across countries, a consensus of policy reforms is hard to reach. Because of the supranational nature of the decisionmaking process, and the need for quasi-unanimous

³Denmark and Ireland were in a different situation, welcoming high prices, as they were "exporting" countries with a large farm sector.

agreement, compromise and bargaining will continue to take place, as vested interests of some social groups are treated as national interest in the Council of Ministers.

This supranational nature of the CAP leads to an externality problem in the institutional framework, as it is possible to externalize partly the budgetary and economic costs of price support policies on other partners, thanks to the financial solidarity principle. The net importers lose in that game and they take any opportunity, particularly when the unanimity voting is the rule rather than the exception, to bargain some specific program which is geared toward their own national interests. This has led the CAP into a situation where programs are very complex and cumbersome to implement. This has also led to the upward bias in the price decisions every year, as can be seen in table 3 below.

Table 3--Annual changes in support prices: Decisions versus proposals

Year	Proposals		Decisions			
	In ECU (a)	In national currency (b)	In ECU (c)	In national currency 1/ (d)	Inflation rate 2/ (e)	Support prices in real terms (e)-(d)
1980/81	2.4	--	4.8	10.5	12.1	-1.6
1981/82	8.9	--	9.2	10.9	10.6	.3
1982/83	9.0	--	10.4	12.2	10.5	1.7
1983/84	4.4	4.4	4.2	6.9	8.6	-2.3
1984/85	.8	-.5	-.5	3.3	7.0	-3.7
1985/86	-.4	0	+.1	1.8	6.0	-4.2
1986/87	-.1	.9	-.3	2.2	5.5	-3.3
1987/88	-.5	.2	-.2	3.3	4.0	-.7
1988/89	0	.3	-.1	1.6	3.9	-2.3
1989/90	-.2	.6	-.3	1.3	3.7	-2.4

-- = Not available or not applicable.

1/ Including monetary adjustment. 2/ First year of split year.

Source: Eurostat, National Accounts; Notes Rapides de l'Europe Verte, 14, 21, 23, 27, 30, 35, 41, 44; CCE-- EC Commission, com (89) 40/1.

The new CAP, as presented in the first section, should not lead us to forget that the traditional CAP is still alive. It will prevent drastic changes from happening, but will probably develop according to the following lines:

- o Price support reduced slowly as a response mainly to budget pressure.
- o Production kept under control (quota, MGQ).
- o National measures to compensate income losses, pursued particularly in richer countries (Germany and France).
- o Direct aids financed from common European resources kept under check.

- o Resource adjustment policies implemented (set-aside, early retirement...), but with a limited impact on surpluses.
- o Burden of price support largely maintained on the consumer and the user to prevent expanding budget cost.
- o Decisionmaking process and MCAs or VAT mechanisms biased toward ECU price increases, so that producer prices in Germany do not fall in an unacceptable way.

A fully market-oriented policy or an elimination of the CAP are unlikely. Rather, the trend leans toward budget-saving and income-preserving policy reforms which may end up being more inward looking than internationally open and relying on supply management policies rather than on decoupling and income transfer. To a large extent, France's role in the CAP has allowed these traditional features to develop in the past 30 years.

France's Strategies and Role Within the CAP: After the Sweets, the Sour Grapes?

The traditional approach of farm policy in France has been biased in favor of protectionism and an extensive intervention of the State in the sector. Again, the roots have to be traced back to the 19th century at least (as in the case of Germany) with the Meline tariffs providing a shelter from international competition. In the postwar period, farm policy was designed to restore the production capacity of the sector, and soon the need for structural adjustment was felt and an active structural modernization policy was carried in the Golden Sixties, when economic growth was fast enough to absorb labor freed by the farm sector. This is also the period when the CAP was implemented and the fairly protectionist habits were taken. From the point of view of a French analyst, the two important questions today are:

- o Whether the choices made over the last 30 years in the CAP were really the right ones in regard to economic efficiency and longrun national interest.
- o Whether it is still possible today to shift the strategy to more sound economic foundations.

Relevant questions are also whether it was possible to envisage a different historical scenario, and whether the CAP has really contributed to build an agricultural sector ready to face future challenges. By and large, the choices made in that period are often better explained by a political rather than an economic rationale.

A Shortrun Strategy

It was long thought that higher prices obtained in Brussels were a good thing for France. As the agricultural common market was built around the grain sector, the high price policy for grains was considered as a good for France, in view of the production capacity and the large farms of the Paris basin. High price policy was the option retained for most sectors where European production was significant, in particular for sugar and animal products (save maybe for pork and poultry).

France's trade balance has always been fragile, and the contribution of the farm and food industries to the external balance was seen as an asset in meeting macroeconomic targets. This is why France has never fought very actively for lower common prices which Germany has always wanted high anyway, to protect their relatively small farm structures.

It is clear that agricultural trade in France has benefited from the CAP and that the value of exports of the crop sector would not have been the same without the CAP. France has been able to externalize part of the cost of the price support policies. One may question, however, if the longrun negative effects of the high grain price policy are not large enough to offset the shortrun benefits on the balance of payments.

First, by keeping feed grain prices high, France has somewhat choked the growth of the animal sector not only for pork (for which the country is a permanent large net importer) and poultry, but also for dairy and beef which had to compete with profitable crops for land. The record of France in the animal sector is far from being in line with the country resources, even without taking Netherlands as a normal reference.

Second, high grain prices have led to concessions on the external tariff for other feedstuffs which has created the cereal substitute issue in Europe and to some extent stimulated the import demand for protein feed. This has closed a significant part of the internal European market to French exports of grains, notwithstanding the increased self sufficiency of partners (U.K. is now a net exporter of barley), and made the exports of grain depend on restitutions.

To rewrite history is impossible, but it is questionable whether that was really the best way to ensure a sound positive balance in our agricultural trade in the long run. The sugar quota system is probably even a better example of the drawbacks of such a strategy. Clearly with that system, France has not played the cards of comparative advantage, and all countries have requested their market share, including the ones who are prone to make pleas for free market policies.

Most of the ingredients usually included in the political economy of agricultural protection seem to apply to the French example as well. Until recently, the share of farmers in employment and in the votes was still important. Their representation in the unions was controlled by the larger farmers who favor high prices paid by passive consumers rather than social subsidization programs. It is probable that without the CAP the parameters of the political game would have been different and prices would have been lower in France.

The heterogeneity of French agriculture also contributed to make price cuts more difficult, as some farmers could stand lower prices, while small farmers are close to the poverty line. The common view was also that farmers should "earn their income from the market," that is, the consumer. Under such circumstances, prices are never high enough when small and fairly poor farmers are brought into the front scene.

One would be tempted to argue also that little contradiction was given by the general thinking about farm problems including the agricultural economics profession itself, which was fairly biased toward agrarianism and the small farm problems. This may relate to the long tradition of protectionism which was not even questioned in the 1960s and certainly less in the 1970s where economists were, to say the least, not biased in

favor of market-oriented policies but explained that the capitalist forces were the main causes of the problem.

It is doubtful that more widespread critical analyses of the French farm policies would have made a great difference on the observed developments, at least in regard to the German case where economists have long been critical without apparently affecting deeply the course of events up to now. Policy reforms require more than good economic analysis to be implemented. Changes in the political economy of decisionmaking or in the nature of the problems are necessary for a reorientation to occur as we observe now. It can be argued, however, that a better explanation of the opinion that labor had to move out of the farm sector and that regional economic development cannot depend on farm price support might have helped the country to take greater advantage of the rapid growth of the 1960s to improve its competitiveness in agriculture.

The Time for Sound Resolutions

The favorable trade balance in food and agriculture should not generate any illusion. Exports are mainly composed of raw products and little of high-value-added items. Animal products have some weak points (pork, sheep). Given the overall self-sufficiency of the EC, the dependency of our exports to third countries on FEOGA subsidies threatens our exports in the long run, even more so as budget costs are scrutinized and as our partner countries become more and more reluctant to contribute to enhance our export capability.

This weakened situation has already materialized in the slow deterioration of balance of payment transfers from the CAP within agriculture, and the net financial balance for France has now become limited and sensitive to future price cuts in surplus commodities. It can be argued that the type of specialization of French agriculture induced by the CAP has to be phased out as in all other member states, and comparative advantage can no longer be played as easily as it was in the period of growth of total agricultural output.

This viewpoint is no longer rare in France, where a significant change in the mood, a "frémissement" as we say, can be felt in the public agencies and even in the farmer organizations. The consensus over the unquestioned virtues of price support is now broken and a debate is going on. Certainly, the new pressures on the CAP have contributed to this increased awareness, but the new momentum of the European construction due to the Single Act and 1992 has also started bearing on the events.

1992: The Single Market Will Affect the CAP in the Long Run

It is not easy to predict how much progress will be made by 1992 on European integration as a result of the Single Act, but there will be progress. It is widely recognized that the direct effects on agriculture and the CAP should be limited since all the necessary legal basis for market unity for agricultural products has been available since the Treaty of Rome. It is likely, however, that the indirect effects of 1992 on the CAP could be significant in the long run if the integration of the rest of the European economy goes far enough to include the common currency and the removal of borders.

In regard to agriculture and the food industry, the single market is likely to impact first through the necessary harmonization of nontariff barriers on food products; second, by the harmonization of macroeconomic policies and of the regulations in sectors supplying inputs and services to agriculture; and third, by the general political climate generated by 1992 and the reordering of priorities it may lead to in European affairs.

The Single Market and the Food Industry

The removal of nontariff barriers related to health regulation and consumer protection will open a very large market to the European and foreign firms of the food industry which meet the required standards. This increase in competition is supposed to enhance efficiency and allow firms to take advantage of economies of scale. The cost of "non-Europe" in the food industry has been evaluated to be from 600 to 1,200 million ECU annually in the Cecchini Report. This estimate is at best tentative, but the increasing-returns nature of the food industry does not leave much doubt on the sign of the efficiency gains. The larger firms have already taken this for granted as shown by the intense activity of consolidation and purchasing of shares to gain control over the European market (163 alliances in 1988 according to Viaene, 1989).

How does the French food industry stand in face of this increased competition? The size of the industry is similar to the one of Britain and Germany, but it does not quite match the relatively large capacity of the French farm sector in Europe. This is reflected in the composition of the trade of agricultural and food products which include a limited amount of elaborated goods of the so-called second transformation which has a high-value added. The net trade balance is negative in this category (4.1 billion francs in 1987 while the global surplus is 27.2 billion francs in the agricultural and food balance). By comparison, Germany and the Netherlands do much better with surpluses of respectively 3.7 billion and 7.3 billion francs (Gagey, 1989).

This relatively poor performance may be due to the economic structure of the industry where firms are smaller than in our European partners. Few corporations are big enough (with the exception of BSN, 7th largest in Europe) to serve as a leader in equity restructuring and firm acquisition to reach a size sufficient for the new European market.

The geographic zone of influence is also a matter of concern for the French food industry, as the domestic market is by and large the essential outlet for most firms. For example, the group BSN makes 70 percent of its sales in France, while Nestle sells 70 percent of its production out of Europe.

The relatively modest scale of the French food firms may also contribute to the explanation of the weakness of research and development in that sector (R & D spending is reported to be 0.12 percent of turnover in France as compared to 0.7 or 0.8 percent in the United States). The balance of payments for licenses has consistently been negative in that sector since 1978, and the purchase-to-sales ratio of licenses has been 0.11 in the food industry as compared to 0.44 in the rest of the economy (Gupta and Vincent, 1986).

To summarize, the structure and performance of the French food industry is barely adequate, even if it should be able to benefit from the traditional image of quality in some products. The firms must adapt to the new trends in food habits, specialize in

areas where markets expand, and enlarge their size and geographical coverage if they are to take advantage of the single market. The cooperative firms in the food industry which are extensive in France will find adjustment to a rapidly changing environment particularly demanding.

At the core of the issue of the removal of intra-community trade barriers for food products is the process of food law harmonization among member states. Up to now, the general approach to this question is the principle of mutual recognition which was stated by the Court of Justice of Luxembourg in the famous case, "Cassis de Dijon," and in several other cases generating a jurisprudence along these lines. According to this principle, a product legally manufactured and sold in a member state must be sold without legal obstacle in the whole Community.

In the annex to the White paper (CCE-- EC Commission-- Livre Blanc, 1985), the Commission lays the guidelines for the implementation of the Single Market in the food industry. The Commission took the position of limited regulations, drafting directives aimed at labeling legislation on additives, material, and equipment rather than an official control of foodstuffs content, i.e., the "recipe approach."

France has issued a memorandum on the completion of the internal market for food law which is based on four concerns:

- o The close link between food and health and the sensitivity of the public opinion to these issues.
- o The importance of sales denominations and qualitative specification in regard to consumer protection and fair trading.
- o The existence of varied national rules which reflect the richness of food tradition in Europe.
- o The interaction of the single market for food law and the "acquis communautaire," i.e., the working of the CAP.

The memorandum essentially expresses concern about the possible risk for quality of foodstuffs if they are economically forced to adjust down to the level of the country with minimum standards as a result of the mutual recognition principle. It reflects some doubts on the efficiency of the free market system in the context of consumer safety.

There is some economic substance in this position which should not be viewed as a sole desire to preserve genuine food traditions or as a petty gastronomic parochialism. The memorandum accordingly favors a horizontal harmonization of general standards, rules of inspection, and labeling. It also favors a vertical harmonization for a limited number of foodstuffs in regard to the sales denominations ⁴ and the composition of products. The introduction of a standardization policy at the Community level is also suggested to approve standards and professional practices. We take it that in the United States the

⁴It suggests to distinguish generic denominations which all countries would have to comply with, and country specific denominations for which an inventory is requested.

harmonization of standards is viewed as a positive feature allowing the foreign firms to meet ahead of time a unique set of conditions for the whole European market.⁵

1992 and the CAP

The single market will modify the environment of the CAP, rather than impact directly upon it. First, harmonization of policies in the area of indirect taxes is likely to be an issue of importance considering the large divergences in VAT rates applied to farm inputs and food. The outcomes of such an harmonization are unclear. There may be differential effects among member states as a large number of farmers in EC countries (except U.K., Denmark, and the Netherlands) still use the special VAT regulations since they do not carry complete bookkeeping records.

Second, the single market should make the transportation industry more competitive in Europe and decrease the cost of food and feedstuff transportation. These goods are bulky and this in itself is likely to reduce the still existing price differentials in farm and food products among member states. Comparative advantage should work more efficiently and specialization of regions might increase. A similar effect may result from the single market in the banking system and more generally in the farm input industry.

Third, market unification in foodstuffs, even if the process is not completed by 1992, will probably increase the pressure on the CAP in the areas of highly protected raw materials which hamper the competitiveness of the food industry. The acceleration in the use of biotechnology techniques is likely to enhance the competition emanating from substitutes for traditional food or feed products, and distorting price policies will be harder to maintain in the long run.

Fourth, the frontier-free Europe and the single market principle will make nationally managed production and import quotas, national aids and targeted variable premium (beef and veal), as well as the MCAs look at odds with the general trend of fostering economic integration and market competition. In that respect, however, we do not see as likely in the near future the phasing out of production quotas in dairy, and even in sugar. There are so many built-in interests now in these sectors that an income problem has been transmuted into an asset problem which makes it even more irreversible.

The issue of MCAs is probably different in that the borders will eventually fall and a common currency will be implemented if the political will keeps its current momentum.⁶ Then, one can hardly see the custom officials being kept at work just for the sake of monitoring MCAs. Because the forces at work behind the CAP are still there, national aids will develop, particularly in Germany, sometimes using environmental objectives as a pretext rather than as a fundamental rationale.

This new setting should partly cut the biases toward price increases in Europe as some of the transfers will become more visible on the budget and will therefore trigger some political debate regarding the merits of their longrun distributional impacts. In any case,

⁵See D. Kelch paper in this symposium.

⁶The borders may, however, still last a while if only for controlling live animal flows, as many areas in Europe are not free from swine and bovine disease.

this general trend will also foster the competition on markets as the user price will be less closely linked to the producer price.

Fifth, the general political climate will have an impact on the future of the CAP, as it will no longer be the unique symbol of an integrated Europe. This has already been felt by the farmers themselves who reveal in public polls that they have lost some faith in Europe as the solution to their problems.

Sixth, the expected gain in GNP growth rate as a result of the single market and the decreased inflation should relieve some pressure on the farm sector which could benefit from some stimulation on the demand side and from better trends in input/output price ratios. This more buoyant economic outlook, if it does materialize, should also help the adjustment of the CAP a lot by creating jobs and attracting resources from the farm sector -- a better economic outlook than the sluggish growth of the last decade.

Last, there is increasing concern in many member states, particularly the northern members, that pollution and damage to the environment by agriculture may add significant pressure toward less intensive farming. Recent policies such as the set-aside or nitrogen regulations, do not suggest however that environmental goals are likely to be pursued through lowering price supports.

Conclusion and Summary

The CAP has already made significant adjustments to control surpluses and budget expenditures. 1992 and the single market will bring some new pressure for a gradual adaption of the CAP to the concept of border-free Europe.

These changes will remain limited in the near future, however, since the CAP, as any other policy, is trapped in a network of contradictory forces which limit the margins of maneuver. The budget will continue to be the leading force behind the changes, and any budget-saving policy instrument which does not hurt farmers' incomes will remain popular among policymakers. As farmers do not like direct payments, decoupling will not develop to a large scale, unless well-accepted and economically sound instruments of transfers are invented as a reward to farmers for their role as keepers of nature.

This situation is not so unusual in developed countries, and the plea for free trade is always made by countries in areas where they have a comparative advantage. This is why the United States and others have only grain and not dairy or sugar programs in mind when they advocate free trade or even market-oriented policies. There is a high correlation between the economic rationale and national interest in that context. It may be that, as in induced innovation theory, many economic research programs and policy prescriptions are also induced by national interests and the economic and political environment.

In that context, while protectionist in most sectors, the CAP is not so unusual as it is often portrayed and it can be qualified as a fairly common agricultural policy. This has implications for the GATT in that the dominant forces at work being domestic, limited commitments are most probably to be expected.

The single market and "relance européenne" will nevertheless change some of the cards in the farm policy game. Some policies may just turn out to be too hard to implement

in a border-free Europe, and others may be caught under increased critical review as being in contradiction with the spirit of 1992 and with the increasingly felt need to preserve the quality of the environment.

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EC 1992: What's in Store for the United States

by

Walter H. Gardiner

Introduction

The European Community has undertaken an ambitious program to consolidate its internal market, often referred to as "Europe 1992", "Project 1992", or simply "1992." While much attention over the past decade has been focused on the dynamism of the Pacific Rim with the remarkable economic performance of Japan and the newly industrialized countries in South East Asia, new attention is being focused on Europe because of the changes which are occurring there as a result of the 1992 program.

The goal of Europe 1992 is to achieve a true common market as was originally envisaged by the founders of the European Community nearly 33 years ago. The reason for this initiative is the realization that physical, technical, and fiscal barriers have prevented the EC from achieving greater economic efficiency and economic welfare. Europe 1992 is a 7-year legislative program which began in 1985 to remove those barriers which frustrated the free movement of goods, services, people, and capital between the EC member countries.

The United States has taken a keen interest in the EC's 1992 program because of its trade links and investments in Europe. While the United States continues to embrace the goal of a unified Europe, concerns have been raised about some of the directives that stem from the 1992 program which could restrict market access in the future. The label "Fortress Europe" has been used by a number of U.S. and other non-EC officials to describe the potential market and investment environment that could emerge out of EC 1992 if third countries are not vigilant in monitoring the progress of the directives as they become part of EC commercial law. EC officials have made numerous attempts to reassure their trading partners that the 1992 program will pose increased trade and investment opportunities for all.

Costly Internal Trade Barriers

The plethora of trade barriers and the wide differences in standards and regulations among EC member countries had become painfully apparent. A recent report on 1992 by Michael Calingaert points out how severe some of these barriers had become:

- o Delays at borders due to custom checks result in a 750-mile trip from London to Milan taking 58 hours (excluding the channel crossing) compared with 36 hours for a comparable distance in the U.K.
- o A person travelling through 10 of the EC member countries and returning home would end up with only 53 percent of the money he or she began with because of the cost of changing currency.

- o A European television manufacturer has to make seven types of television sets to meet member country standards, requiring 70 engineers to adjust new models to individual country requirements at a cost of \$20 billion.
- o EC member countries debated the standards for fork-lift trucks for 10 years before reaching an agreement, the principal point of dispute being the appropriate pedal system.

Obstacles that have prevented the attainment of a truly common agricultural sector include:

- o National quotas and subsidies related to production and trade.
- o Green rates of exchange which are used to translate EC policy prices into national currencies.
- o Monetary compensatory amounts (MCAs) which are border taxes or subsidies designed to prevent "trade distortions" caused by price differentials between countries as a result of the green rate mechanism.
- o A wide range of technical regulations and standards that relate to products and services as well as animal, plant, and human welfare.
- o Differences in tax rates--value added tax (VAT) and excise taxes.

Motivation for EC 1992

The EC made much progress toward the goal of unifying its market in its first 20 years of existence with the removal of tariffs and quotas among member countries, elimination of most restrictions on foreign exchange for trade and investment purposes, formation of a common external trade policy at the Community level, and some achievements in product standardization. However, the oil price shocks of the 1970s and subsequent inflation, economic stagnation, and unemployment in Europe stalled the unification process as member countries began enacting various measures to protect their industries and markets. Progress toward full integration was further impeded by the accession of the United Kingdom, Ireland, and Denmark in 1973 and Greece in 1981 which brought about additional administrative and financial burdens (Calingaert, p.6).

The process to restart the EC's program of completing the Common Market began in the early 1980s with a series of communications from the EC's executive arm, the Commission, and a number of special reports which pointed out the lack of integration in the so-called Common Market and the associated economic cost to the Community for failing to complete its internal market. The program became more formalized beginning in 1982 with decisions by the European Council, the EC's principal decisionmaking body made up of the heads of state of the member countries. At its meeting in Brussels in March 1985, the Council endorsed the goal of completing the Common Market and authorized the Commission to draw up a detailed program for achieving this goal.

The blueprint for this program of economic integration is contained in a White Paper entitled Completing the Internal Market, issued by the Commission to the Council in

June 1985. The report contains some 300 directives regarding the removal of physical, technical, and fiscal barriers between member countries and a timetable for action with an overall deadline of December 31, 1992. The program is to be carried out with three principal objectives in mind:

- o The unification of the 12 member countries into a single market of 320 million people.
- o Ensuring that the single market is expanding and not stagnant.
- o Ensuring that the market is flexible so that all resources will be free to move to areas of greatest economic advantage.

The Commission acknowledges that the changes implied by this comprehensive program will cause considerable difficulties for some member countries, but that the benefits to a fully integrated Community are so great that they should not be denied to its citizens (Commission, p. 7).

Barriers to be Removed

In its White Paper for completing the internal market, the Commission identifies the physical, technical, and fiscal barriers that still exist between member countries, explains why they should be removed, and provides a timetable for implementing the proposed program.

Physical Barriers

The customs posts at the borders to member countries are the most overt sign of the continued lack of a unified market in the EC. It is at the borders where the movement of goods and people are controlled because of differences in currencies, laws, and regulations that still exist between EC countries, including immigration controls, taxation, health and safety standards, and product pricing. The border controls impose a large cost on the movement of goods and people through time delays and fees which add to the cost of doing business and reduce efficiency.

Technical Barriers

Even if the borders are removed, the flow of goods, services, individuals, and capital would be impeded by divergent national legislation on regulations and technical standards. These include such things as product regulations; animal, plant, and human health standards; packaging and labeling requirements; and testing and certification procedures.

Fiscal Barriers

Differences in taxation, both direct and indirect, among member countries are another area that project 1992 seeks to harmonize. The removal of borders has profound implications for commerce because of these tax differentials.

Potential EC Gains from Project 1992

According to the Cecchini report, a 2-year, \$5 million study involving 200 people commissioned by the EC to quantify the impacts of the 1992 Project, the benefits to the EC from completing the internal market could be quite substantial:

- o A 4- to 7-percent increase in gross domestic product.
- o A 6-percent reduction in consumer prices.
- o An increase in 2-5 million jobs.

Changes implied by the 1992 program are also expected to impose significant adjustment costs for some businesses, consumers, and local governments where new standards and regulations are more stringent than those that currently exist.

Why 1992 is Important to the United States

Project 1992 will also have important implications for the EC's trading partners, especially the United States. The United States and the EC share a number of important economic relationships that indicate the degree of interdependence that has emerged between these two regions. The United States and the EC comprise the world's two leading economic blocs, combining for about one-half of the world's gross domestic product and merchandise trade. U.S. GDP in 1988 totaled \$3,425.5 billion (1980 dollars) compared with \$3,677.9 billion for the EC (table 1). U.S. merchandise exports in 1988 totaled \$301.3 billion (current dollars), or less than one-third that exported by the EC. As the EC has expanded from the original 6 members in 1957 to the current 12 members, so has the size of the market that is subject to EC laws and regulations.

Table 1--U.S. and EC GDP and merchandise exports, 1988

Region	GDP	Merchandise exports
	Bil. 1980 US\$	Bil. US\$
World	14,795.8	2,785.6
United States	3,425.5	301.3
EC-12	3,677.9	1,037.8

Source: (WEFA GROUP).

The United States and the EC are each other's largest trading partner with two-way trade totaling \$156.6 billion in 1988. U.S. merchandise exports to the EC have risen nearly sixfold, from \$12.3 billion in 1970 to \$72.5 in 1988 (table 2). Over the same time period, U.S. imports from the EC have increased nearly ninefold, from \$9.7 billion to \$84.1 billion. The United States was running a fairly healthy trade balance with the EC until the mid-1980s when the situation reversed itself and the United States became a net importer of EC merchandise. In 1986, the United States ran a trade deficit of \$22.6 billion with the Community, but by 1988, the trade deficit was cut by half to \$11.5 billion.

Table 2--U.S. merchandise exports, imports and trade balance: EC-12 and world

Items	1970	1975	1980	1985	1986	1987	1988
<u>Million dollars</u>							
Exports to EC-12	12,339	25,906	58,691	48,996	53,155	60,575	72,549
Imports from EC-12	9,719	17,836	37,882	67,822	75,736	81,188	84,086
Trade balance with EC-12	2,620	8,070	20,809	(18,826)	(22,581)	(20,613)	(11,537)
Exports to world	43,224	107,592	220,783	213,146	217,304	252,866	308,014
Imports from world	39,952	96,902	244,871	345,276	369,961	405,901	437,140
Trade balance with world	3,272	10,690	(24,088)	(132,130)	(152,657)	(153,035)	(129,126)
<u>Percent of world</u>							
Exports to EC-12	29	24	27	23	24	24	24
Imports from EC-12	24	18	15	20	20	20	19

Source: U.S. Dept. of Commerce. Statistical Abstract of the United States, 1989, p. 788-89; 1979, P. 862-63.

While U.S. trade with the EC has continued its upward growth over the past three decades, its role in the context of total U.S. trade with the world has diminished somewhat. Between 1970 and 1988, U.S. exports to the EC as a share of total U.S. exports to the world fell from 29 percent to 24 percent. At the same time, the share of U.S. imports from the EC fell from 24 percent to 19 percent. While this implies that a smaller share of U.S. trade will be affected by developments stemming from the 1992 program, it still represents a sizable share of U.S. trade abroad.

Trade in agricultural products is a significant component of U.S.-EC trade, though its importance has diminished substantially in the 1980s. U.S. exports of agricultural products to the EC totalled \$2.3 billion in 1970, peaked at \$11 billion in 1980, and fell 41 percent to \$6.5 billion in 1985 (table 3). Increased EC self-sufficiency for a number of agricultural commodities, combined with a strong U.S. dollar and high U.S. support prices accounted for most of the decline.

With the weakening of the dollar relative to European currencies near the end of 1985, exports began to recover slightly in 1986, rising to \$7.3 billion by 1988, but amounting to only two-thirds the record level set in 1980. The EC's share of total U.S. agricultural exports also declined during this period--32 percent in 1970 to 20 percent in 1988--with agriculture's share of U.S.-EC merchandise trade falling from 19 percent to 10 percent.

Viewing trade from the EC perspective, the United States is the largest foreign supplier of agricultural and food products to the EC with 1980 sales totaling \$13.8 billion, or 22 percent of the EC total (table 4). A comparison with figures for 1987 indicates a reduced role for the United States (\$8.7 billion or 15 percent of the total) while most other countries increased in importance, particularly Colombia, Thailand, Australia, and Yugoslavia.

It is also interesting to note that between 1980 and 1987, EC imports of agricultural and food products from countries outside the EC (extra-EC) fell nearly 5 percent while trade among EC countries (intra-EC) rose 56 percent. This result is consistent with the theory about customs unions, that is, they are trade-creating for countries within the customs union and trade-diverting outside. This development is one of the reasons for concern by countries outside of the EC that the 1992 program could lead to a "Fortress Europe."

Table 3 -- U.S. agricultural exports: EC-12 and total

Items	1970	1975	1980	1985	1986	1987	1988
<u>Million dollars</u>							
Exports to EC-12	2,316	6,769	11,033	6,477	6,627	6,880	7,315
Total U.S. exports	7,255	21,859	41,233	29,041	26,222	28,709	37,093
<u>Percent</u>							
EC-12 share of total	32	31	27	22	25	24	20

Source: U.S. Dept. of Commerce. Statistical Abstract of the United States, 1989, p. 644.

Table 4--EC-12 imports of agricultural and food products

Region	Import value		Change	Share of Extra-EC	
	1980	1987	1987/1980	1980	1987
<u>Million dollars</u>					
World total	115,334	143,084	24.1	--	--
Intra-EC-12	53,889	84,096	56.1	--	--
Extra-EC-12	61,443	58,682	-4.5	100.0	100.0
Industrialized countries	28,310	23,661	-16.4	46.1	40.3
United States	13,769	8,685	-36.9	22.4	14.8
Canada	2,435	1,749	-28.2	4.0	3.0
Australia	1,196	1,740	45.5	1.9	3.0
Sweden	1,461	1,685	15.4	2.4	2.9
New Zealand	1,497	1,535	2.6	2.4	2.6
Japan	270	251	-7.3	.4	.4
Developing countries	28,371	29,681	4.6	46.2	50.6
Brazil	3,886	4,343	11.8	6.3	7.4
Ivory Coast	2,073	1,856	-10.5	3.4	3.2
Argentina	2,239	1,791	-20.0	3.6	3.1
Thailand	1,002	1,524	52.0	1.6	2.6
Colombia	379	1,369	261.5	.6	2.3
Centrally planned countries	4,659	5,339	14.6	7.6	9.1
Soviet Union	1,261	1,271	.8	2.1	2.2
Poland	785	906	15.4	1.3	1.5
Yugoslavia	659	816	23.9	1.1	1.4
Hungary	817	715	-12.6	1.3	1.2

Source: Commission of the European Communities, Agricultural Situation in the Community, 1988 Report, T/153.

The United States is also a major investor in the EC. U.S. direct investment in the Community totalled \$20.1 billion in 1970, accounting for 27 percent of total U.S. foreign investment that year (table 5). By 1987, U.S. investment in the EC rose to \$122.2 billion and accounted for an astounding 40 percent of the total. Thus, the EC 1992 directives that affect the investment climate in Europe will be closely watched.

Table 5--U.S. direct investment: EC-12 1/ and other countries

Items	1970	1975	1980	1985	1986	1987
<u>Million dollars</u>						
Investment in EC	20,104	38,773	77,153	81,337	98,472	122,247
Investment, other	55,376	85,277	138,222	148,913	161,090	186,546
Total foreign investment	75,480	124,050	215,375	230,250	259,562	308,793
<u>Percent</u>						
EC share of total	27	31	36	35	38	40

1/ Denmark, Ireland, and the United Kingdom joined the EC in 1973, Greece joined in 1981, and Spain and Portugal joined in 1986. For consistency, data are shown for the EC-12.

Source: U.S. Dept. of Commerce. Statistical Abstract of the United States, 1989, p. 779; 1979, p. 851.

Conclusions

The EC's 1992 program is attempting to complete the common market in the true economic sense by eliminating all internal barriers to trade. There are no provisions for liberalizing any of the EC's external trade barriers. Any developments here will have to come from success in the current GATT round scheduled to conclude in December 1990. However, the adjustments to investment, production, consumption, and trade patterns within the EC in response to the large number of the 1992 directives will be felt far beyond the EC's borders.

There will be increased opportunities for those able to compete in a deregulated EC economy, especially those companies that are already doing business in the EC and who are making the necessary changes to respond to a pan-European market. Much of the outcome will depend on what level the EC decides to harmonize its standards and regulations. The debate is between the "minimalists" who are pushing for the strictest levels possible and the "maximalists" who prefer to settle more on the average level that exists around the Community. For companies such as equipment manufacturers who are required to build as many as eight production lines for tractors because of different regulations in EC countries, any harmonization should be a welcome development. This also bodes well for smaller companies that only do business in one or two EC countries because of the prohibitive costs of establishing multiple production lines. Eliminating the EC's customs regulations at internal borders should significantly reduce the cost of transporting goods within the Community. This has important implications for both domestic producers and exporters of food and agricultural products.

There are a number of remaining questions of concern to the United States concerning the EC's 1992 program.

- o Will the EC enact standards and regulations more restrictive than currently in place?
- o Will the EC raise new external barriers against third countries in order to protect EC countries from increased competition?
- o Can the United States gain at the expense of EC and third country firms?

The gains for the United States from the 1992 Program will depend on how open the EC is after 1992 and how aggressive the United States is in adapting to the new playing field in Europe.

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